

CalPERS Currency Strategy

Building on Capabilities

Agenda

- Outline of plans
- Currency's role in a portfolio
- Review of CalPERS currency experience
- Active currency strategies in the market
- Proposed plan
- Next Steps and Conclusion

Outline

All existing programs and goals to remain unchanged

Those programs are:

1. Currency Overlay Program with a primary goal to reduce risk and add alpha where possible
2. The Internal Passive portfolio

Outline – What is being considered

In the near future

- Active alpha currency program, as a stand alone, run internally, subject to Board approval

In 2007

- Currency risk reduction to be considered at the overall CalPERS portfolio level, rather than asset by asset as it is presently

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Currency's role in a Portfolio

In its most simple form....

Currency policy should either seek

- 1) To reduce portfolio **risk** or
- 2) To increase portfolio **return**

Currency's Role in a Portfolio

- Diversification
- Reduction of portfolio volatility
- Alpha: multitude of empirical evidence show that *it exists*

Agenda

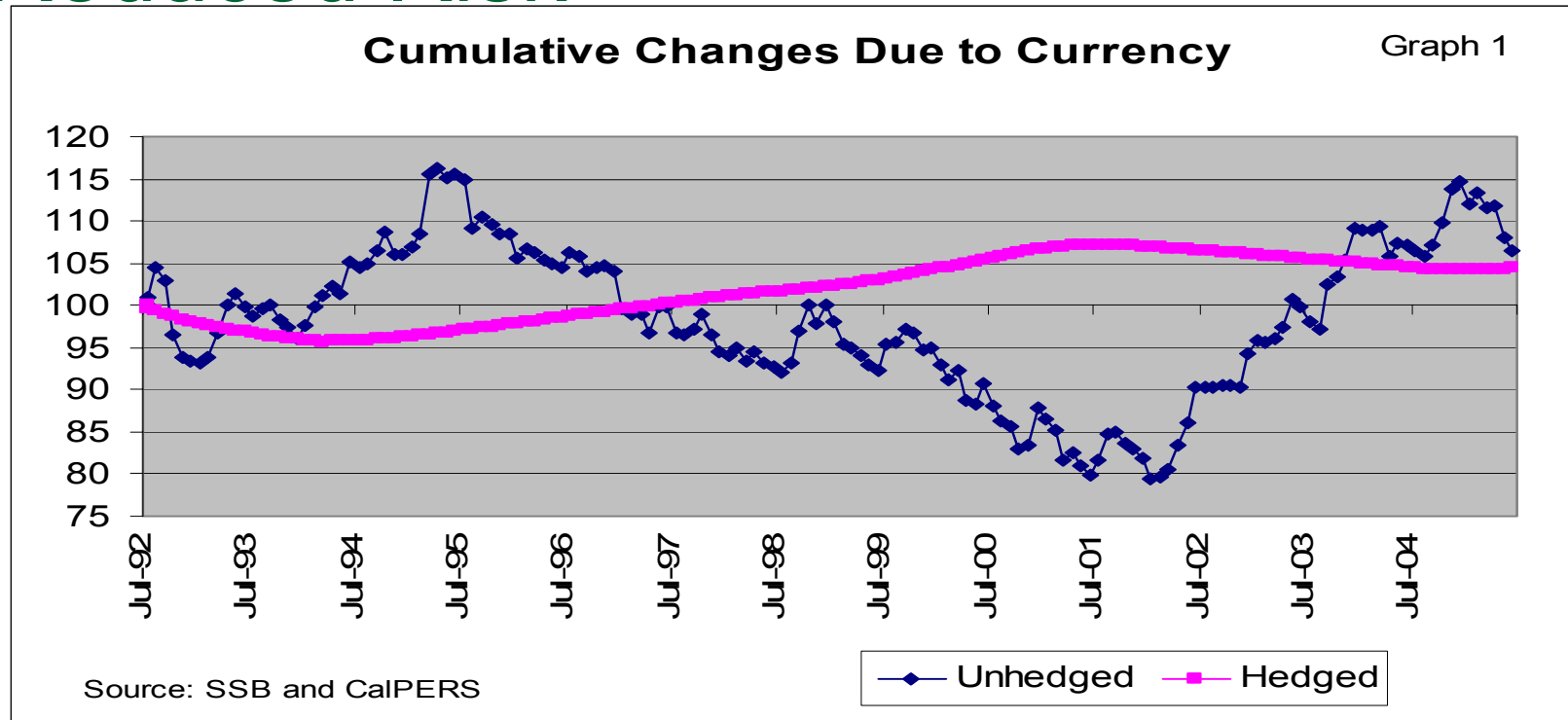
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CalPERS currency activities primarily emphasize risk reduction, as decided by the IC in 1991

Currency Overlay Program Consists of

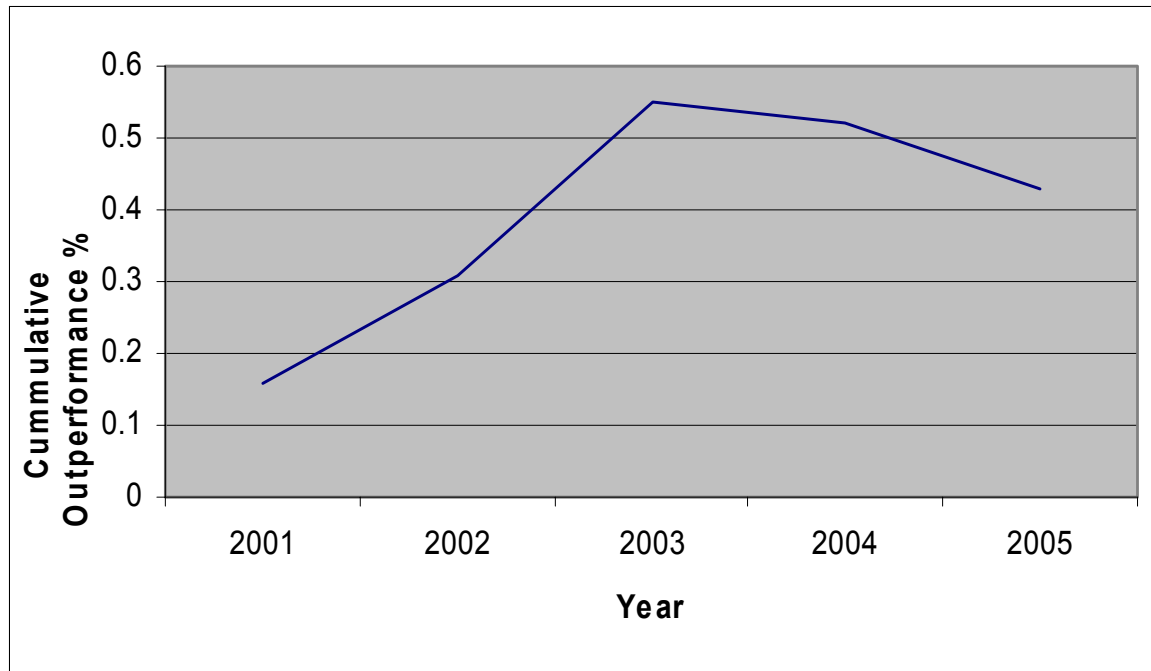
- Externally managed quasi-active portfolios
- Internally managed passive hedge portfolio (inception 2001)

CalPERS Total Currency Program Has Reduced Risk



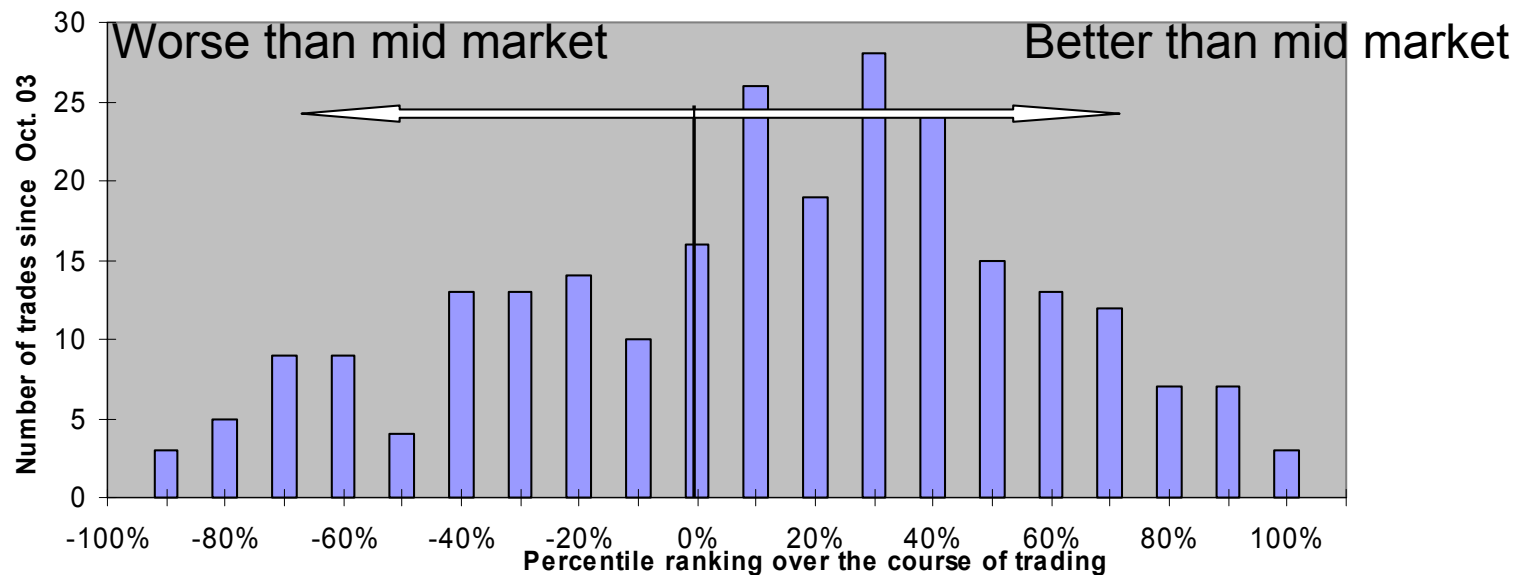
- The blue line is the unhedged currency return (i.e. no overlay)
- The pink line is CalPERS hedge benchmark portfolio
- Smoother is less volatile – 41 bps annualized since inception

Internally Managed Passive Portfolio has reduced risk; without the expected negative tracking error



Results: exceeded benchmark by 43 bps since inception

Internal execution of CalPERS currency needs. One would have expected a normal distribution...

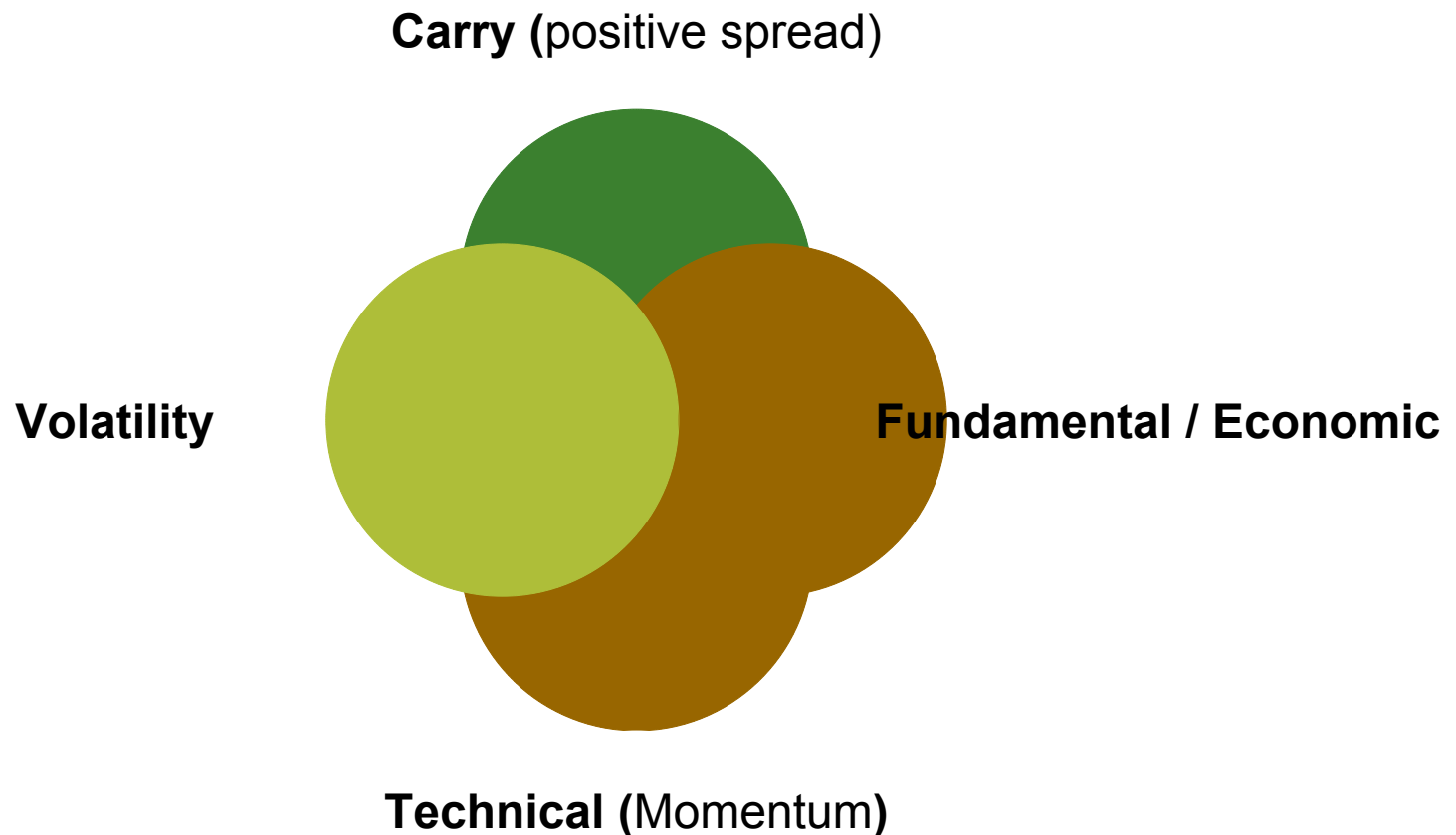


- CalPERS result is positively skewed with a saving of approximately \$4 million relative to previous alternative

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Active Currency Investment Styles



Currency Styles

- **Carry** – driven by spreads that exist on forward currency
- **Fundamental** – driven by measurable economic data
- **Technical** - driven by price changes, momentum
- **Volatility** – driven by the rate of change of prices

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Based on the 4 Currency Styles

- Forge and maintain strategic relationships with major players
- Develop internal quantitative models to suit each style
- Develop strategies for allocating capital to various styles
- Develop and maintain risk control measures and guidelines through Policy Subcommittee

We propose an addition of active currency program with emphasis on generating return

- Thus far the focus has been on risk reduction. We propose changing the focus to include RETURN, as well as risk reduction.
- Stand alone currency alpha program will start small and build only after positive results.
- This will utilize both internally and externally managed portfolios

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Next Steps

We plan to...

- Bring an agenda item to the IC for an internal active alpha program
- Subject to IC approval: Develop guidelines for active alpha to be approved by the Policy Subcommittee
- Plan an RFP for external active alpha managers

We are not...

- Changing existing programs
- Restricting any asset class from investing internationally, be it hedged or unhedged

2007 and beyond

- In 2007 at the Asset Allocation Workshop, consider currency at the total fund level
- Conduct an RFP for external active alpha managers

Conclusion

- CalPERS has had a successful currency program
- Existing programs should remain unchanged
- Staff is working toward an internal active currency alpha program
- Currency risk should be considered at the overall CalPERS portfolio level
- Conduct an RFP for external active alpha managers in 2007